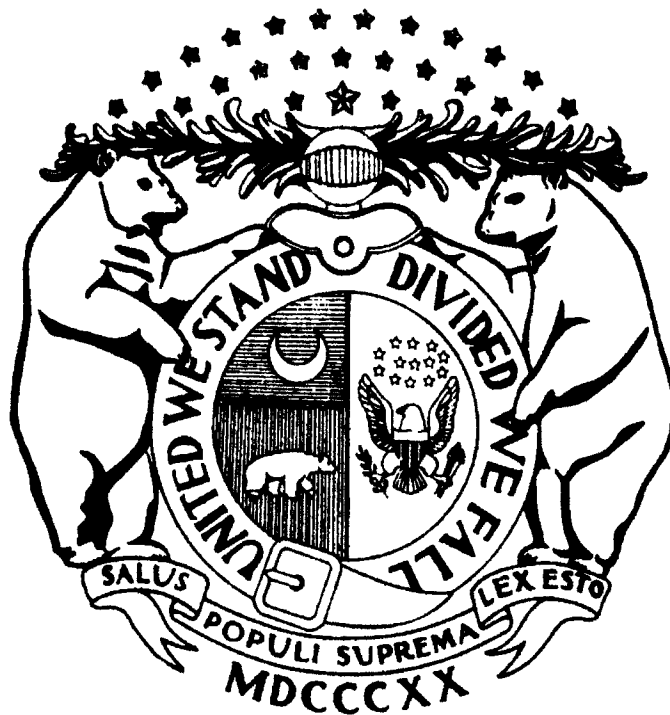


REPORT OF  
ASSOCIATION FINANCIAL EXAMINATION  
  
**AMERICAN AUTOMOBILE INSURANCE COMPANY**

AS OF  
DECEMBER 31, 2003



STATE OF MISSOURI  
DEPARTMENT OF INSURANCE  
JEFFERSON CITY, MISSOURI

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Novato, California  
May 12, 2005

Honorable Alfred W. Gross, Commissioner  
Virginia Bureau of Insurance  
Chairman of Financial Condition (EX4) Subcommittee

Honorable Jorge Gomez, Commissioner  
Wisconsin Department of Insurance  
Midwestern Zone Secretary

Honorable W. Dale Finke, Director  
Missouri Department of Insurance  
301 West High Street, Room 530  
Jefferson City, Missouri 65101

Sirs:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

**American Automobile Insurance Company**

hereinafter referred to as such, as the "Company" or as "AAIC." Its main administrative office is located at 777 San Marin Drive, Novato, California, 94998, telephone number (415) 899-2000. This examination began on December 16, 2003 and on-site fieldwork by examiners from the Missouri Department of Insurance was concluded on July 15, 2004. This examination was held open pending the finalization of the examinations of affiliated companies by the California Department of Insurance (CDI) on the above date as significant reliance was placed on the CDI examination.

## **SCOPE OF EXAMINATION**

### **Period Covered**

The prior comprehensive financial examination of American Automobile Insurance Company was made as of December 31, 1999, and was conducted by examiners from the State of Missouri representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC).

The current full scope association financial examination of the Company covers the period from January 1, 2000, through December 31, 2003, and has been conducted by examiners from the State of Missouri representing the Midwestern Zone of the NAIC with no other zones participating. This examination was done in conjunction with the examination that was conducted by the Missouri Department of Insurance of the Company's affiliate, Fireman's Fund Insurance Company of Missouri, and the examination conducted by the California Department of Insurance of Fireman's Fund Insurance Company, Associated Indemnity Corporation, San Francisco Reinsurance and Vintage Insurance Company.

This examination also included the material transactions and/or events occurring subsequent to the examination date which are noted in this report.

### **Procedures**

This examination was conducted using the guidelines set forth in the Financial Condition Examiners Handbook of the NAIC, except where practices, procedures and applicable regulations of the Missouri Department of Insurance (MDI) and statutes of the State of Missouri prevailed. Significant reliance was placed upon the California

Department of Insurance examination of Fireman's Fund Insurance Company, its systems and controls, and the reinsurance pool.

The examiners relied upon information supplied by the independent auditor, KPMG LLP, of San Francisco, California, from its audit covering the period from January 1, 2003, through December 31, 2003. This information included, but was not limited to, attorney letters, account analysis information, and internal control evaluations.

#### **Comments-Previous Examination**

Listed below are notes, comments, and recommendations of the previous examination report dated as of December 31, 1999, and the subsequent response or action taken by the Company.

#### **Conflict of Interest**

**Comment:** Conflict of interest statements were not completed by any of the appointed officers for the years 1997 and 1998 and not all appointed officers completed statements for the year 1999. The Company was directed to ensure that conflict of interest statements are executed annually by all elected and appointed directors and officers.

**Company's Response:** Our practice was to only solicit signed statements from directors, elected officers, and certain key employees. Some employees, who are not considered key employees, were appointed officers of our companies to facilitate various form filings. Since the Missouri Examiner-in-Charge has recommended that we change our practice, procedures have been established to also solicit statements from all employees with appointed titles beginning with our 2002 annual distribution.

**Current Findings:** The Company provided completed Conflict of Interest Statements for all elected and appointed directors and officers for the years under examination.

### **Intercompany Transactions**

**Comment:** A review of the records associated with the Marketing Agreement, indicated that the Company could not provide adequate documentation to support the accounting of the marketing fees incurred in each of the years under examination. In accordance with Missouri Regulation 20 CSR 200-4.010 (Books, Records, Accounts and Vouchers), the Company was directed to ensure that all books, documents and other business records are maintained for a period of not less than three years and in an order so that its financial condition may be readily ascertained by the Department of Insurance.

**Company's Response:** It is the Company's policy to maintain all business records for a period in excess of three years to provide for financial examinations from the Department of Insurance. In this instance, the marketing agreement relates to discontinued operations of the Company. All records were transitioned between offices and archiving records were misplaced. A review of the archiving procedures surrounding discontinued operations was undertaken to ensure that all necessary records are maintained for financial examinations going forward.

**Current Findings:** The Company provided adequate supporting documentation for the intercompany transactions for the current examination.

### **Internal Control System**

**Comment:** The Company was directed to ensure that reconciliations are prepared on a periodic basis, reviewed and approved by management, and provided when requested during future financial examinations.

**Company's Response:** Reconciliations between the Premium Dispersion & Accounting (PDA) system and the general ledger were completed in 1999. In 2000, the Company implemented a new ledger by PeopleSoft. All "system" premiums began interfacing directly to the general ledger from the corporate data repository, ARCHIVE. System reconciliations are now performed weekly between the PDA, ARCHIVE, and general ledger systems by Information Technology resources ensuring accurate reporting of premium levels.

**Current Findings:** Problems were noted in the current examination concerning reconciliations between the sub-ledgers and the general ledger. See the "Accounts and Records" section of this report for discussion.

**Comment:** A review of the accounting records of the Company indicated errors had occurred in the recording of the commission payable liability that was reported in the 1999 Annual Statement. The Company was directed to develop and implement adequate procedures and controls to ensure that entries posted to the general ledger are reviewed and approved by a responsible member of management, properly recorded to the ledger, and appropriately reported in the Annual Statement in accordance with the instructions set forth by the NAIC.

**Company's Response:** During 1999, cash reclassifications from premiums receivable to commissions payable were not booked into the general ledger as should



have occurred. This problem was recognized internally in 2000 and correcting entries were subsequently made to correctly state the offsetting account for cash disbursement. After review, the Treasury department systems interface to the general ledger representing cash activity for the Company was redirected, eliminating the need for manual reclassification and ensuring that commissions payments were offsetting the commissions payable liabilities.

***Current Findings:*** No problems were noted during the current examination with this area.

***Comment:*** After a review of the various general ledger accounts that comprised the sundry liabilities line item at December 31, 1999, it was noted that the Company incorrectly offset unrelated debits and credits. In addition, the Company was unable to provide supporting documentation on behalf of the reported amounts. It was recommended that the Company only offset debit and credit balances in instances where the right to offset exist. In addition, in accordance with Missouri Regulation 20 CSR 200-4.010 (Books, Records, Accounts and Vouchers), the Company was directed to ensure that all books, documents, and other business records are maintained for a period of not less than three years.

***Company's Response:*** The Company reviewed both the sundry asset and liability balances in the general ledger. Any balances lacking documentation or considered otherwise non-supportable were written off.

***Current Findings:*** No material problems were noted in the current examination with this general area.

## **HISTORY**

### **General**

American Automobile Insurance Company was incorporated on December 14, 1911, under the laws of Missouri and was issued a certificate of authority on January 1, 1912. The Company operates under provisions of Chapter 379 RSMo (Insurance Other Than Life).

In 1956, The American Insurance Company of Omaha, Nebraska, acquired financial control of the Company. On December 31, 1963, The American Insurance Company was acquired by Fireman's Fund Insurance Company, with complete financial control held by The Fund American Companies, Inc., of Greenwich, Connecticut. On January 2, 1991, Fireman's Fund Insurance Company and its subsidiaries were sold to Allianz of America, Inc. On December 1, 1995, The American Insurance Company sold its 100 percent ownership interest in the Company and its subsidiary, Associated Indemnity Corporation, to Fireman's Fund Insurance Company.

### **Capital Stock**

As of December 31, 2003, the Company was wholly owned by Fireman's Fund Insurance Company. The Company had 1,750,000 authorized shares of common stock with a par value of \$2. As of December 31, 2003, all authorized shares were issued and outstanding for a total balance of \$3.5 million in the AAIC common capital stock account.

### **Dividends**

No dividends were declared or paid to the sole shareholder during the period under examination.

### **Management**

Pursuant to Article III of the Company's Amended and Restated Bylaws, the Company's Board of Directors shall consist of nine (9) directors duly elected at each annual meeting of the shareholder. The directors elected and serving at December 31, 2003, were as follows:

<u>Name and Address</u>	<u>Business Affiliation</u>
Janet S. Kloenhamer Larkspur, California	Senior Vice President, General Counsel, & Secretary Fireman's Fund Insurance Company
H. David Lundgren <sup>1</sup> Tiburon, California	Executive Vice President Fireman's Fund Insurance Company
Joseph J. Beneducci Santa Rosa, California	Exec. Vice President & Chief Administrative Officer Fireman's Fund Insurance Company
Thomas E. Geissler Mill Valley, California	Senior Vice President, Discontinued Operations Fireman's Fund Insurance Company
Peter Huehne <sup>1</sup> Tiburon, California	Executive Vice President & Chief Financial Officer Fireman's Fund Insurance Company
Jill E. Patterson Tiburon, California	Senior Vice President & Controller Fireman's Fund Insurance Company
Jeffrey H. Post <sup>1</sup> Novato, California	President and Chief Executive Officer Fireman's Fund Insurance Company
Alastair C. Shore <sup>1</sup> Novato, California	Senior Vice President Fireman's Fund Insurance Company
Linda E. Wright Tiburon, California	Senior Vice President and Treasurer Fireman's Fund Insurance Company

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<sup>1</sup> During 2004, Misters Lundgren, Huehne, Post, and Shore were replaced as AAIC board members by Bruce F. Friedburg, Louise Jordan, Charles M. Kavitsky, and David C. Sargent.

Article V, Section 5.1 of the Company's Amended and Restated Bylaws provide that the officers of the Company shall consist of a Chairman of the Board of Directors, a President, a Secretary, a Treasurer and such other officers as the Board of Directors may deem appropriate. The officers elected and serving as of December 31, 2003, were as follows:

<u>Name</u>	<u>Title</u>
Jeffrey H. Post <sup>2</sup>	Chairman of the Board of Directors, President, & Chief Executive Officer
Peter Huehne <sup>3</sup>	Executive Vice President & Chief Financial Officer
Janet Kloenhamer	Senior Vice President, General Counsel, & Secretary
Linda E. Wright	Senior Vice President & Treasurer

In each of the years under examination, the Board of Directors established an executive committee for the primary purpose of managing the affairs of the Company. The members elected and serving on the executive committee as of December 31, 2003, were as follows: Jeffrey H. Post, Peter Huehne, and H. David Lundgren.

### **Conflict of Interest**

The Company's policy dictates conflict of interest statements are to be executed annually by all elected directors and officers. Signed statements were reviewed for the directors and officers during the examination period. No material conflicts were revealed.

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<sup>2</sup> Effective May 2004, Mr. Post was replaced as Chairman, President, and CEO of AAIC by Charles M. Kavitsky.

<sup>3</sup> Effective January 2004, Mr. Huehne was replaced as Executive Vice President and Chief Financial Officer of AAIC by Peter W. Presperin, who was subsequently replaced by Jill Patterson.

### **Corporate Records**

A review was made of the Articles of Incorporation and Bylaws of the Company for the period under examination. The Articles of Incorporation and Bylaws were not amended during the examination period.

The minutes associated with the actions in lieu of an annual or special meeting of the sole shareholder, the board of directors and the executive committee were reviewed for the period under examination, and appear to properly reflect and approve all material corporate transactions and events of the Company.

### **Acquisitions, Mergers and Major Corporate Events**

There were no acquisitions, mergers, or major corporate events for the period under examination.

### **Surplus Debentures**

There were no surplus debentures issued or outstanding for the period under examination.

## **AFFILIATED COMPANIES**

### **Holding Company, Subsidiaries and Affiliates**

As of December 31, 2003, American Automobile Insurance Company was a member of an Insurance Holding Company System as defined by RSMo. 382.010, (Definitions). The Company is a wholly owned subsidiary of Fireman's Fund Insurance Company (FFIC). FFIC's voting stock is owned entirely by Allianz Global Risks US Insurance Company. Allianz Global Risks US Insurance Company is a subsidiary of

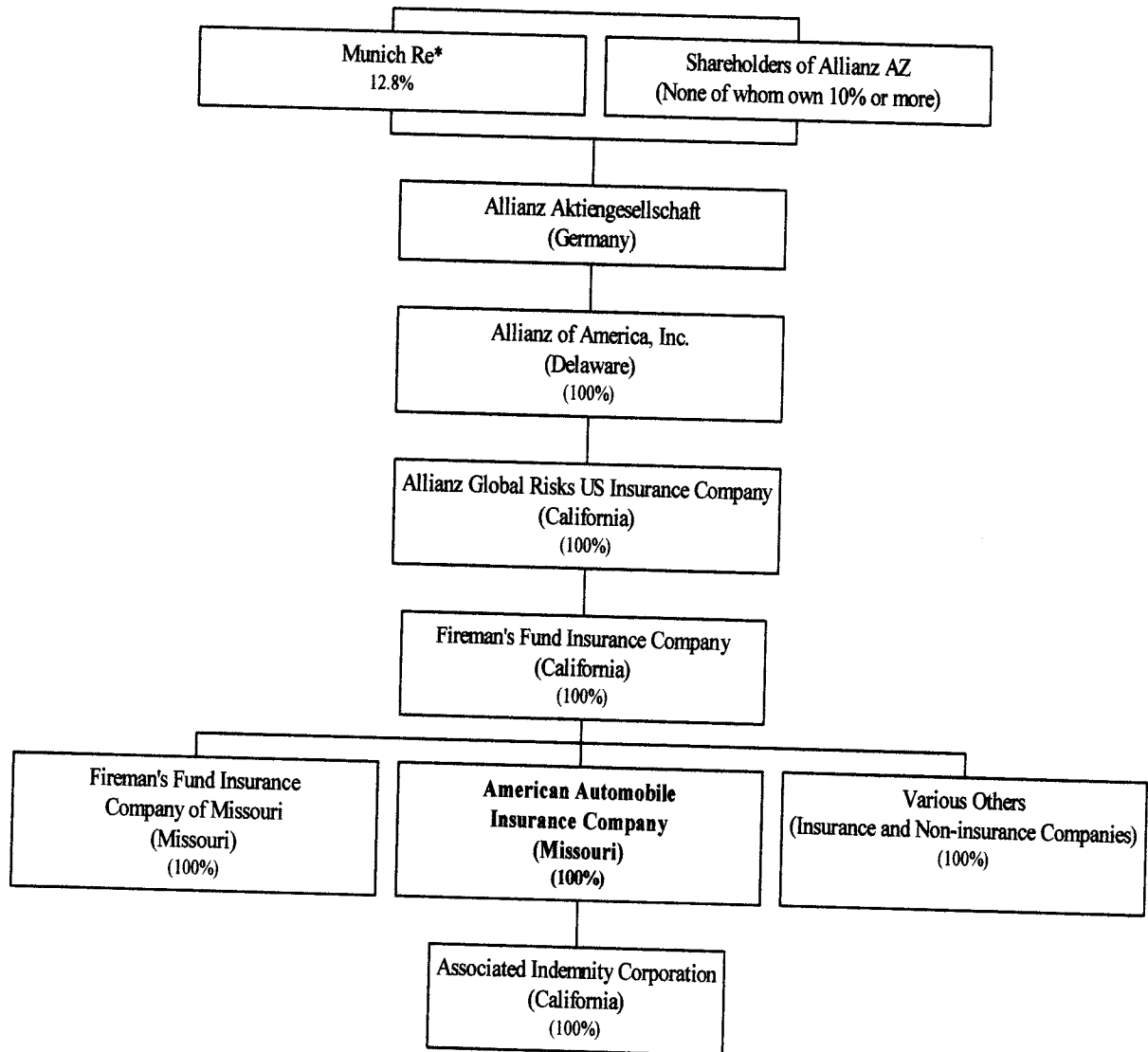
Allianz of America, Inc., whose voting stock is solely owned by Allianz Aktiengesellschaft (Allianz AG). Allianz AG is the ultimate controlling entity within the holding company system.

Allianz AG is a publicly held company traded on the New York Stock Exchange, under the ticker symbol AZ. As of December 31, 2003, there were 366,362,608 shares of AZ common stock outstanding. Munchener Ruckversicherungs-Gesellschaft Aktiengesellschaft in Muenchen (Munich Re) held 46,908,267 shares of the AZ common stock, or 12.8 percent of the outstanding shares on December 31, 2003. However, per a Disclaimer of Control filed with the MDI and dated September 3, 1990, Munich Re does not exercise control over Allianz AG. There were no other individual shareholders, directly or beneficially, who owned 10% or more of the outstanding shares.

During the period under examination consolidated Insurance Holding Company System Registration Statements were filed by and on behalf of American Automobile Insurance Company, and its affiliated insurer, Fireman's Fund Insurance Company of Missouri.

### **Organizational Chart**

The following organizational chart depicts the applicable portion of the holding company group, including AAIC as of December 31, 2003:



\* Muenchener Rueckversicherungs-Gesellschaft Aktiengesellschaft in Muenchen

### **Intercompany Transactions**

The Company entered into various intercompany agreements including:

1.    Type:           Amended Investment Management Agreement  
  
      Parties:       Fireman's Fund Insurance Company (FFIC) and The American Insurance Company, American Automobile Insurance Company, National Surety Corporation, Associated Indemnity Corporation, American Automobile Insurance Company of Illinois and Fireman's Fund Insurance Company of Wisconsin  
  
      Effective:     January 1, 1983  
  
      Terms:        FFIC agrees to perform all administrative, accounting, clerical, statistical, and corporate services that are required in connection with the administration of the investment affairs of all parties to this agreement. In consideration for these services provided, each party to this agreement agrees that within ten working days after the end of each month, its percentage of the monthly cost incurred by FFIC will be remitted. This percentage shall be calculated by dividing the amount of invested assets shown on page 2, lines 1, 2.1 and 2.2 of the Company's annual statement as filed with the National Association of Insurance Commissioners for the year ending December 31, by the total of such assets shown for all parties to this agreement.
  
2.    Type:           Tax Reimbursement Agreement  
  
      Parties:       Allianz of America, Inc. (AZOA) and Fireman's Fund Insurance Company (FFIC) and some of its insurance subsidiaries  
  
      Effective:     December 31, 1991 (Amended December 17, 1999)  
  
      Terms:        This agreement provides that a consolidated return will be filed by AZOA for each taxable year. The tax liability or refund due from or to each member of FFIC's insurance subsidiaries will be computed as if each member filed a separate stand-alone Federal return. All payments required pursuant to this agreement shall be made at the time, and in the amounts, such payments would have been required to be made to the Internal Revenue Service had each member filed a separate stand-alone return. However, final settlement shall be made within 90 days after the filing of the consolidated returns with the Internal Revenue Service.



3. Type: Limited Liability Company Operating Agreement
- Parties: Allianz Cash Pool LLC and Affiliated Insurance Companies of Fireman's Fund Insurance Company (Members).
- Effective: January 1, 1996
- Terms: The Allianz Cash Pool LLC was organized as a limited liability company in the state of Delaware and was formed for the purpose of pooling and investing capital contributions made by member companies. The capital contributions made by each member are to be invested in short-term debt obligations issued by or on the behalf of the United States; corporate debt obligations (other than debt obligations issued, assumed or guaranteed by a participant or an affiliate of a participant); and accounts, deposits or obligations of banks insured by an agency of the federal government.

Following is a table of the fees incurred under the above described American Automobile Insurance Company intercompany agreements (excluding the tax agreement). This table shows the other party to the agreement, the agreement name, and the dollar amount incurred by AAIC under each agreement for 2000, 2001, 2002, and 2003:

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Fireman's Fund Insurance Company - Investment Mgmt. Agreement	\$296,414	\$383,174	\$326,829	\$426,320
Allianz Cash Pool LLC - Operating Agreement	<u>NF</u>	<u>NF</u>	<u>NF</u>	<u>NF</u>
Totals	<u>\$296,414</u>	<u>\$383,174</u>	<u>\$326,829</u>	<u>\$426,320</u>

NF = No fees were paid or due to or from AAIC under this agreement during the exam period.

In addition to the intercompany agreements described above, AAIC also ceded business to FFIC through an Intercompany Reinsurance Agreement. Under this agreement, FFIC, AAIC and other FFIC subsidiaries agree to pool all underwriting operations and insurance business. AAIC's participation in this agreement is 2.5%. The

Company amended the Intercompany Reinsurance Agreement on January 1, 2003. However, the Company did not file the amendment with the Missouri Department of Insurance (MDI) for prior approval as required by RSMo 382.195 (Transactions within a holding company system). AAIC is directed to file this amendment immediately, and ensure that all future agreements and amendments to agreements are filed with the MDI on a timely basis. This agreement is described in the Reinsurance section of this report.

In June 2002, the reinsurance pool described above sold overdue premiums and reinsurance recoverables to Allianz of America, Inc. ("AZOA") without recourse. Pursuant to the sales agreement, the pool continued to provide services pertaining to the maintenance and collection of these receivables. On a quarterly basis, monies collected by the pool were remitted to AZOA. In June 2003, the pool companies made an early settlement, or buy-back, from AZOA totaling \$33.7 million for the entire pool. Upon settlement, the pool had not collected a portion of these recoverables, resulting in the transfer of financial risk from AZOA to the Company. This transfer of risk contradicts the provision of the sales agreement, which states the sale is "without recourse." The Company should abide by the terms of all current and future intercompany sale agreements and account for the sale transactions in accordance with SSAP 42, *Sale of Premium Receivables*.

During the examination period, AAIC both received capital contributions and contributed capital to its subsidiary. On February 28, 2003, AAIC received a capital contribution of \$36.4 million from its parent, FFIC, and AAIC paid a capital contribution of \$10.4 million to its subsidiary, Associated Indemnity Corporation. On February 27, 2003, the Company received approval from the Missouri Department of Insurance for

both capital contributions and to allow the capital contributions to be effective as of December 31, 2002. The net effect of the capital contributions for AAIC was \$26 million.

### **FIDELITY BOND AND OTHER INSURANCE**

American Automobile Insurance Company is the named insured, along with other subsidiaries of Allianz of America, Inc., on a Financial Institution Bond policy, which carries a single loss limit of \$10 million per occurrence, subject to a single loss deductible of \$1 million. AAIC is also covered as a named insured on additional policies providing coverages which include, but are not limited to, the following: Umbrella Liability, Computer Crime, Property Liability, Workers' Compensation, General Liability, and Automobile.

### **PENSION, STOCK OWNERSHIP AND INSURANCE PLANS**

American Automobile Insurance Company has no direct employees. Services are provided primarily by FFIC, pursuant to an intercompany reinsurance agreement described in the Intercompany Transactions and Reinsurance sections of this report. The typical employee benefits are available to employees of the Allianz holding company system including, but not limited to, pension, 401(k), health care, dental, short-term and long-term disability, and group life insurance. The expenses for these benefits are charged to AAIC through intercompany service fees. Other than any unpaid billings under intercompany agreements at year-end 2003, AAIC had no additional liability for the benefits provided.

## STATUTORY DEPOSITS

### Deposits with the State of Missouri

The funds on deposit with the Missouri Department of Insurance as of December 31, 2003, as reflected below, were sufficient in par and market value to meet the deposit requirements for the State of Missouri in accordance with RSMo Section 379.098 (Insurance other life-Security deposits).

<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Stmt Value</u>
U.S. Treasury Notes	\$2,500,000	\$2,683,981	\$2,551,333

### Deposits with Other States and Territories

The Company also has funds on deposit with various other states in which it is licensed. Those funds on deposit as of December 31, 2003, were as follows:

<u>State or Territory</u>	<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Stmt Value</u>
Arizona	U.S. Treasury Note	\$757,000	\$810,467	\$772,704
California	Special Revenue Obligation <sup>1</sup>	19,030,000	20,682,779	19,107,175
Delaware	U.S. Treasury Note	110,000	117,769	112,282
Georgia	U.S. Treasury Note	205,000	219,479	209,253
Idaho	U.S. Treasury Bond & Note	81,000	90,358	84,544
Louisiana	U.S. Treasury Note	70,000	78,400	71,205
Massachusetts	U.S. Treasury Note	2,009,000	2,257,078	2,134,213
Nevada	U.S. Treasury Note	100,000	105,719	100,123
New Mexico	U.S. Treasury Note	350,000	374,721	357,261
North Carolina	U.S. Treasury Note	300,000	333,043	317,217
Ohio	U.S. Treasury Note	100,000	107,063	102,075
Oklahoma	U.S. Treasury Note	300,000	321,189	306,224
Oregon	U.S. Treasury Bond & Note	575,000	619,187	589,961
Tennessee	U.S. Treasury Note	750,000	802,973	765,559
Virginia	U.S. Treasury Note	500,000	529,876	508,425
<b>Totals</b>		<u>\$25,237,000</u>	<u>\$27,450,101</u>	<u>\$25,538,221</u>

<sup>1</sup> Includes Surplus Note with Equitable Life Assurances.

## **INSURANCE PRODUCTS AND RELATED PRACTICES**

### **Territory and Plan of Operations**

The Company is licensed by the Missouri Department of Insurance under Chapter 379 RSMo. (Insurance other than life), to write property and casualty insurance. As of December 31, 2003, the Company was licensed in all fifty states and the District of Columbia.

Underwriting operations are conducted through the following two segments that service the individual insurance buyer and the corporate customer, respectively: Personal Lines Segment and Commercial Business Segment. The Personal Lines Segment's customer base is composed of buyers of traditional homeowners and automobile products. The Commercial Business Segment's customer base is composed of groups and associations, middle market, and small to medium size businesses, generally with fewer than 50 employees. AAIC's products are primarily marketed through independent agents. The Company's largest product lines are commercial multi-peril and other liability – occurrence. More than 50 percent of the Company's direct premiums are written in California, Florida, Illinois, Massachusetts, Missouri, and New York.

### **Policy Forms and Underwriting** **Advertising & Sales Material** **Treatment of Policyholders**

The Missouri Department of Insurance has a market conduct staff which performs a review of these issues and generates a separate market conduct report. The last MDI Market Conduct Examination Report [#MO189-M59] dated January 21, 2000, was reviewed during the prior examination and no material discrepancies were noted. A Florida Market Conduct Examination and a Connecticut Market Conduct Examination

were performed as of 2001 and 2002, respectively. These reports were reviewed and no problems were noted which would have a material impact on AAIC's financial condition.

## REINSURANCE

### General

The Company's reinsurance and premium activity during the period under examination are as follows:

<u>Premiums Written:</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Direct Business	\$392,386,093	\$385,353,235	\$473,681,710	\$469,414,240
Reinsurance Assumed:				
Affiliates	100,200,443	62,331,116	101,700,808	79,401,896
Non-Affiliates	0	0	3,551	1,818
Reinsurance Ceded:				
Affiliates	(392,386,093)	(385,353,235)	(473,685,261)	(469,415,810)
Non-Affiliates	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Net Premiums Written	<u>\$100,200,443</u>	<u>\$ 62,331,116</u>	<u>\$101,700,808</u>	<u>\$ 79,402,144</u>

### Pooling

AAIC, along with Fireman's Fund Insurance Company (FFIC) and seven other insurance subsidiaries of FFIC, is a party to an Intercompany Reinsurance Agreement. Under the terms and conditions of this agreement, each subsidiary or pool member is required to cede 100% of its direct and assumed business to its parent, FFIC, the lead insurer in the intercompany pool. Under this pooling agreement, the participants share all underwriting and insurance business and related assets, liabilities, income and expenses according to their participation percentages. Pooled accounts do not include investment operations, dividends to stockholders, or federal income tax liabilities.

In addition to the parties to the Intercompany Reinsurance Agreement, other insurance subsidiaries of Fireman's Fund Insurance Company cede 100% of their direct and assumed business to the pool. Under separate reinsurance agreements, the following insurance subsidiaries of FFIC cede 100% of their direct and assumed business to the pool and receive a zero participation percentage in the net retained pooled business: American Standard Lloyd's Insurance Company, Fireman's Fund County Mutual Insurance Company, Fireman's Fund Indemnity Corporation, Fireman's Fund Insurance Company of Georgia, Fireman's Fund Insurance Company of Hawaii, Fireman's Fund Insurance Company of Louisiana, Fireman's Fund Insurance Company of Missouri, Fireman's Fund Insurance Company of Nebraska, Midway Insurance Company of Illinois, and Vintage Insurance Company.

Fireman's Fund Insurance Company is then responsible for securing external reinsurance on behalf of the entire pooled business and redistributing the net retained pooled business to each participant in accordance with the percentages stated within the Intercompany Reinsurance Agreement. At December 31, 2003, the following members or participants retained the following percentage of the net retained pooled business:

<u>Participating Company</u>	<u>Percentage</u>
Fireman's Fund Insurance Company	75.0%
The American Insurance Company	11.5%
National Surety Corporation	4.0%
<b>American Automobile Insurance Company</b>	<b>2.5%</b>
Associated Indemnity Corporation	1.0%
Fireman's Fund Insurance Company of Ohio	0.2%
Interstate Fire & Casualty Company	3.5%
Chicago Insurance Company	1.5%
Interstate Indemnity Company	0.8%
Total	100.0%

On January 1, 1999, the Intercompany Reinsurance Agreement was amended and restated for the purpose of consolidating two separate reinsurance intercompany pooling agreements into the pooling agreement described above and revising the participation percentages of the pool members. AAIC's participation percentage of the net retained pooled business in 1997 and 1998 was four percent (4%). Effective January 1, 2003, the Intercompany Reinsurance Agreement was amended for the purpose of increasing FFIC's percentage from 74.9% to 75% and decrease Fireman's Fund Insurance Company of Wisconsin's percentage from 0.1% to 0.0%.

#### **Assumed and Ceded**

AAIC assumes and cedes premium to its parent, Fireman's Fund Insurance Company, pursuant to the above described Intercompany Reinsurance Agreement. No other reinsurance agreements are currently in-force.

The Company is contingently liable for all reinsurance losses ceded to others. This contingent liability would become an actual liability in the event that an assuming reinsurer should fail to perform its obligations under its reinsurance agreement with the Company.

#### **ACCOUNTS AND RECORDS**

Financial statements of the Company were audited by the CPA firm KPMG LLP, of San Francisco, California, for the years ending December 31, 2003, 2002, 2001, and 2000.



Loss reserves of the Company were reviewed and certified as of December 31, 2003, 2002, 2001 and 2000, by David Heyman, FCAS, MAAA, Vice President, Loss Reserve Officer, and Actuary of Fireman's Fund Insurance Company, AAIC's parent.

During the course of the examination, a review was made of the pooled companies' general controls over its information systems by the California Department of Insurance. As a result of this review, recommendations for improving the Company's information systems controls were developed and presented to the Company by the CDI. The recommendations covered areas such as logical security, physical security and program changes. The Company should evaluate these recommendations and make appropriate changes to strengthen controls over its information systems.

During the CDI's review of the pooled companies' reconciliation of certain general ledger accounts, the CDI noted it was a common practice by the Company to rely on a sub-ledger balance as an acceptable form of supporting documentation without reconciling the sub-ledger balance to the detail. The Company also used e-mail as supporting documentation, although less common. The Company should implement controls to ensure that general ledger accounts are reconciled to the system from which the data feeding the general ledger resides.

## **FINANCIAL STATEMENTS**

The following financial statements, with supporting exhibits, present the financial condition of the Company for the period ending December 31, 2003. Any examination adjustments to the amount reported in the Annual Statement and/or comments regarding such are made in the "Notes to the Financial Statements". (The failure of any column of numbers to add to its respective total is due to rounding or truncation.)

There may have been differences found in the course of this examination which are not shown in the "Notes to the Financial Statements". These differences were determined to be immaterial, concerning their effect on the financial statements. Therefore, they were communicated to the Company and/or noted in the workpapers for each individual Annual Statement item.

	<u>Assets</u>		
	<u>ASSETS</u>	<u>ASSETS NOT ADMITTED</u>	<u>NET ADMITTED ASSETS</u>
Bonds	\$177,034,725		\$177,034,725
Common stocks (Note 1)	47,046,798		47,046,798
Other invested assets (Note 1)	19,670,123		19,670,123
Receivable for securities	11,423		11,423
Investment income due and accrued	2,230,016		2,230,016
Premiums and considerations (Notes 2 and 3)	19,736,706	2,138,957	17,597,749
Net deferred tax asset	63,098,168	56,647,298	6,450,870
Receivable from parent, subsidiaries and affiliates (Note 2)	3,765,902		3,765,902
Other assets nonadmitted	161,404	5,276	156,128
Aggregate write-ins for other than invested assets	<u>117,588</u>	<u>0</u>	<u>117,588</u>
Total Assets	<u>\$332,872,853</u>	<u>\$58,791,531</u>	<u>\$274,081,322</u>

**Liabilities, Surplus and Other Funds**

Losses and loss adjustment expenses	\$139,127,490
Commissions payable, contingent commissions & similar charges	2,883,145
Other expenses	1,750,898
Taxes, licenses and fees (excluding federal income taxes)	1,501,203
Unearned premiums	44,778,249
Advance premiums	(2,477)
Dividends declared and unpaid – policyholders	90,175
Aggregate write-ins for liabilities	<u>181,724</u>
Total Liabilities	<u>\$190,310,407</u>
Common capital stock	3,500,000
Gross paid in and contributed surplus	85,525,000
Unassigned funds (surplus)	<u>(5,254,085)</u>
Surplus as regards policyholders	<u>\$ 83,770,915</u>
TOTAL LIABILITIES AND SURPLUS	<u><u>\$274,081,322</u></u>

**Statement of Income**

Underwriting Income	
Premiums earned	\$97,317,440
Deductions	
Losses incurred	\$56,778,982
Loss expenses incurred	12,442,193
Other underwriting expenses incurred	<u>30,922,416</u>
Total underwriting deductions	<u>\$100,143,591</u>
Net underwriting gain/(loss)	(\$2,826,151)
Investment Income	
Net investment income earned	\$9,386,194
Net realized capital gains or (losses)	<u>1,062,039</u>
Net investment gain or (loss)	\$10,448,233
Other Income	
Net gain or (loss) from agents' or premium balances charged off	(200,349)
Aggregate write-ins for miscellaneous income	<u>(6,647)</u>
Total other income	<u>(\$206,996)</u>
Net income before dividends to policyholders and federal income taxes	\$7,415,086
Dividends to policyholders	<u>32,014</u>
Net income (loss)	<u>\$7,383,072</u>

**Capital and Surplus Account**

Surplus as regards policyholders, December 31, 2002	\$81,851,635
Net income	7,383,072
Net unrealized capital gains or (losses)	6,915,608
Change in net unrealized foreign exchange capital gain (loss)	(1,185)
Change in net deferred income tax	60,543,168
Change in non-admitted assets	(57,798,633)
Net examination change	<u>(15,122,750)</u>
Net change in surplus as regards policyholders for the year	<u>1,919,280</u>
Surplus as regards policyholders, December 31, 2003	<u>\$83,770,915</u>

## NOTES TO THE FINANCIAL STATEMENTS

<b>Note 1 – Common Stock</b>	<b>\$47,046,798</b>
<b>Other Invested Assets</b>	<b>19,670,123</b>

At December 31, 2003, Common Stock was reduced by \$14,290,194 to \$47,046,798, and Other Invested Assets was increased by \$14,290,194 to \$19,670,123, due to a reclassification of the Allianz Cash Pool LLC investment. The Company reported its investment in the Allianz Cash Pool LLC on Schedule D, Part 2, Section 2 of the 2003 Annual Statement as a common stock investment. Per SSAP 48, *Joint Ventures, Partnerships and Limited Liability Companies*, the Company should be reporting this investment on the Annual Statement's Schedule BA as an Other Invested Asset. Based on a review of the Company's 2004 Annual Statement, it appears the reporting for this item was corrected in 2004.

<b>Note 2 – Premiums and Considerations</b>	<b>\$17,597,749</b>
<b>Receivables from Parent, Subsidiaries and Affiliates</b>	<b>3,765,902</b>

At December 31, 2003, the Premiums and Considerations asset was reduced by \$1,872,673 to \$17,597,749, and Receivables from Parent, Subsidiaries and Affiliates was increased by \$1,872,673 to \$3,765,902. The Company did not include general ledger account numbers 164800 and 164810 as part of the pooled balance for the Asset line item for Premiums and Considerations. The Company reported the full balance of these general ledger accounts on the FFIC 2003 Annual Statement rather than allocating their pooled percentage to the companies participating in the Intercompany Reinsurance Agreement (pooling agreement). The Company should implement controls to ensure all accounts subject to pooling are properly pooled and appropriately allocated to each member.

**Note 3 – Premiums and Considerations**

**\$17,597,749**

The Company could not provide an aging detail on a policy-by-policy basis for all of the over ninety day components of this asset. Consequently, the examiners were unable to determine compliance with paragraph 7 of SSAP 6, *Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*, which addresses the determination of the due date of premium balances due a company. The Company should implement procedures to ensure that over ninety balances due are supported by the underlying policy level detail and ensure this detail is available for review by auditors and regulators.

**Note 4 – Amounts Recoverable from Reinsurers  
Ceded Reinsurance Premiums Payable**

The Company applied reinsurance premiums payable against reinsurance recoverables on paid losses. Paragraph 19 of SSAP 62, *Property and Casualty Reinsurance*, prohibits the offset of such balances. The Company should implement procedures and controls to ensure the Annual Statement presentation of reinsurance recoverables and premiums is consistent with the relevant SSAPs and Annual Statement Instructions.

**Note 5 – Losses and Loss Adjustment Expenses**

**\$139,127,490**

The California Department of Insurance (CDI), pursuant to California Insurance Code (CIC) Section 733(g), retained a consulting actuary for the purpose of providing a full actuarial evaluation of the Company's and other pool members' loss and loss adjustment expense reserves as of December 31, 2003. Based on the analyses performed by the CDI's consulting actuary, it was determined that the range of probable loss and



loss adjustment expense reserve estimates varied from a low of \$5,009 million to a high of \$6,121.8 million. This is the range estimate for all companies participating in the intercompany reinsurance agreement. The CDI has determined its best estimate of loss and loss adjustment expense reserves to be \$5,565.1 million, which reflects a reserve deficiency of \$604,910,000. As a pooled account, 2.5% of loss and loss adjustment expense reserves, or \$15,122,750 would be allocated to the Company, increasing the reserves from the \$124,004,740 shown by the Company to \$139,127,490.

### EXAMINATION CHANGES

Total Capital and Surplus Per Company, December 31, 2003:

Common capital stock	\$ 3,500,000	
Gross paid in and contributed surplus	85,525,000	
Unassigned funds (surplus)	9,868,665	
<b>Total Capital and Surplus</b>		<b>\$98,893,665</b>

Examination Changes (effect on surplus):

	<u>Increase in Surplus</u>	<u>Decrease in Surplus</u>	
<b>Assets:</b>			
Common Stock		\$14,290,194	
Other Invested Assets	\$14,290,194		
Premiums and Considerations		1,872,673	
Receivables from Affiliates	1,872,673		
<b>Liabilities:</b>			
Losses and LAE Reserves		15,122,750	
<b>Totals</b>	<u>\$16,162,867</u>	<u>\$31,285,617</u>	
<b>Net Change</b>			<b>\$(15,122,750)</b>

Total Capital and Surplus Per Examination, December 31, 2003:

Common capital stock	\$ 3,500,000	
Gross paid in and contributed surplus	85,525,000	
Unassigned funds (surplus)	(5,254,085)	
<b>Total Capital and Surplus</b>		<b><u>\$83,770,915</u></b>

## **GENERAL COMMENTS AND/OR RECOMMENDATIONS**

### **Intercompany Transactions (Page 14)**

The Company amended the Intercompany Reinsurance Agreement on January 1, 2003. However, the Company did not file the amendment with the Missouri Department of Insurance (MDI) for prior approval as required by RSMo 382.195 (Transactions within a holding company system). AAIC is directed to file this amendment immediately, and ensure that all future agreements and amendments to agreements are filed with the MDI on a timely basis.

### **Intercompany Transactions (Page 15)**

In June 2002, the reinsurance pool sold overdue premiums and reinsurance recoverables to Allianz of America, Inc. ("AZOA") without recourse. In June 2003, the pool companies made an early settlement, or buy-back, from AZOA. However, a portion of these recoverables were uncollected, resulting in the transfer of financial risk from AZOA to the Company. This transfer of risk contradicts the provision of the sales agreement, which states the sale is "without recourse." The Company should abide by the terms of all current and future intercompany sale agreements and account for the sale transactions in accordance with SSAP No. 42 of the NAIC Accounting Practices and Procedures Manual.

### **Accounts and Records (Page 22)**

During the course of the examination, a review was made of the pooled companies' general controls over its information systems by the California Department of Insurance. As the result of this review, recommendations for improving the Company's information systems controls were developed and presented to the Company by the CDI.

The recommendations covered areas such as logical security, physical security and program changes. The Company should evaluate these recommendations and make appropriate changes to strengthen controls over its information systems.

**Accounts and Records (Page 22)**

During the CDI's review of the pooled companies' reconciliation of certain general ledger accounts, the CDI noted it was a common practice by the Company to rely on a sub-ledger balance as an acceptable form of supporting documentation without reconciling the sub-ledger balance to the detail. The Company also used e-mail as supporting documentation, although less common. The Company should implement controls to ensure that general ledger accounts are reconciled to the system from which the data feeding the general ledger resides.

**Notes to the Financial Statements (Page 28)**

At December 31, 2003, the Company did not include general ledger account numbers 164800 and 164810 as part of the pooled balance for the Asset line item for Premiums and Considerations. The Company reported the full balance of these general ledger accounts on the FFIC 2003 Annual Statement rather than allocating their pooled percentage to the companies participating in the Intercompany Reinsurance Agreement (pooling agreement). The Company should implement controls to ensure all accounts subject to pooling are properly pooled and appropriately allocated to each member.

**Notes to the Financial Statements (Page 29)**

The Company could not provide an aging detail on a policy-by-policy basis for all of the over ninety day components of Premiums and Considerations. Consequently, the examiners were unable to determine compliance with SSAP No. 6, paragraph 7, which

addresses the determination of the due date of premium balances due a company. The Company should implement procedures to ensure that over ninety balances due are supported by the underlying policy level detail and ensure this detail is available for review by auditors and regulators.

**Notes to the Financial Statements (Page 29)**

The California Department of Insurance (CDI) determined the loss and loss adjustment expense reserves shown by the pool as of December 31, 2003 were deficient by \$604,910,000. Of this deficiency, 2.5%, or \$15,122,750, would be allocated to AAIC. The Company should review its reserving process to ensure future reserve estimates are appropriate.

**Notes to the Financial Statements (Pages 28 and 29)**

In several instances, the Company's Annual Statement presentation was incorrect, including the misclassification of its investment in the Allianz Cash Pool LLC and the incorrect offsetting of reinsurance premiums payable against reinsurance recoverables on paid losses. The Company should implement procedures and controls to ensure its Annual Statement presentation is consistent with the relevant SSAPs and Annual Statement Instructions.

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## ACKNOWLEDGMENT

The assistance and cooperation extended by the officers and the employees of American Automobile Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Angela Campbell, CFE, and Steven Koonse, CFE, examiners for the Missouri Department of Insurance, participated in this examination.

## VERIFICATION

State of Missouri )  
County of )

I, Vicki L. Denton, CFE, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of the Company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.

*Vicki L. Denton*

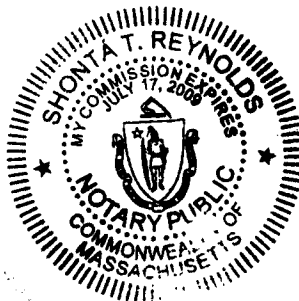
Vicki L. Denton, CFE  
Examiner-In-Charge  
Missouri Department of Insurance

Sworn to and subscribed before me this 10<sup>th</sup> day of August, 2005.

My commission expires:

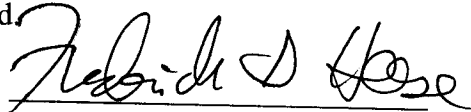
July 17, 2009

*[Signature]*  
Notary Public



### SUPERVISION


The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.



Frederick G. Heese, CFE, CPA  
Audit Manager  
Missouri Department of Insurance

Sworn to and subscribed before me this 10<sup>th</sup> day of August, 2005.

My commission expires: 03/17/2008

  
Notary Public

BEVERLY M. WEBB  
Notary Public - Notary Seal  
STATE OF MISSOURI  
Clay County  
My Commission Expires March 17, 2008



July 28, 2005

Vicki L. Denton, CFE  
Examiner-In-Charge  
Missouri Department of Insurance

RE: American Automobile Insurance Company

Dear Ms. Denton,

The following is a written response to the recommendations discovered during the January 1, 2000 through December 31, 2003 examination of American Automobile Insurance Company as identified in the General Comments and/or Recommendations section of the Missouri Department of Insurance Report of Association Financial Examination.

**1. Intercompany Transactions (Page 14)**

The Company amended the Intercompany Reinsurance Agreement on January 1, 2003. However, the Company did not file the amendment with the Missouri Department of Insurance (MDI) for prior approval as required by RSMo 382.195 (Transactions within a holding company system). AAIC is directed to file this amendment immediately, and ensure that all future agreements and amendments to agreements are filed with the MDI on a timely basis.

*Company Response: RSMo 382.195(3) requires prior notice to the Director of reinsurance agreements with affiliates "in which the reinsurance premium or change in the insurer's liabilities equals or exceeds five percent of the insurer's surplus as regards policyholders." The January 1, 2003 amendment to the Intercompany Reinsurance Agreement had no impact on the reinsurance premium or liabilities of American Automobile Insurance Company (AAIC). The only effect of the January 1, 2003 amendment was to change the pool participation percentages of two of the participating companies, Fireman's Fund Insurance Company and Fireman's Fund Insurance Company of Wisconsin. Since AAIC's participation percentage of 2.5% remained the same, prior notice under RSMo 382.195(3) was not required. The January 1, 2003 amendment is reported on the Form B Annual Registration Statement filed pursuant to RSMo 382.100.*

## **2. Intercompany Transactions (Page 15)**

In June 2002, the reinsurance pool sold overdue premiums and reinsurance recoverables to Allianz of America, Inc. ("AZOA") without recourse. In June 2003, the pool companies made an early settlement, or buy-back, from AZOA. However, a portion of these recoverables were uncollected, resulting in the transfer of financial risk from AZOA to the Company. This transfer of risk contradicts the provision of the sales agreement, which states the sale is "without recourse." The Company should abide by the terms of all current and future intercompany sale agreements and account for the sale transactions in accordance with SSAP No. 42 of the NAIC Accounting Practices and Procedures Manual.

Company Response: *The Company will abide by the terms of intercompany agreements and account for them per the appropriate accounting standards and practices.*

## **3. Accounts and Records (Page 22)**

During the course of the examination, a review was made of the pooled companies' general controls over its information systems by the California Department of Insurance. As the result of this review, recommendations for improving the Company's information systems controls were developed and presented to the Company by the CDI. The recommendations covered areas such as logical security, physical security and program changes. The Company should evaluate these recommendations and make appropriate changes to strengthen its controls over its information systems.

Company Response: *The Company, as a result of the review of information systems controls and the recommendations received, has implemented changes to strengthen its controls over its information systems such as User Account Administration. The Company now utilizes a Lotus Notes Database to request and retain all access change requests and termination requests, and managers are provided with a checklist for terminated employees that includes terminating user ids.*

## **4. Accounts and Records (Page 22)**

During the CDI's review of the pooled companies' reconciliation of certain general ledger accounts, the CDI noted it was a common practice by the Company to rely on a sub-ledger balance as an acceptable form of supporting documentation without reconciling the sub-ledger balance to the detail. The Company also used e-mail as supporting documentation, although less common. The Company should implement controls to ensure that general ledger accounts are reconciled to the system from which the data feeding the general ledger resides.

Company Response: *During 2004, the Company implemented stronger reconciliation processes. This included performing monthly source reconciliations, which reconcile direct system feeds to the general ledger with the related general ledger accounts. These source reconciliations are used as the support for the monthly general ledger account reconciliation. If a general ledger account balance is system supported but not covered through a source reconciliation, a summary or detailed system report is used.*



#### **5. Notes to the Financial Statements (Page 28)**

At December 31, 2003, the Company did not include general ledger account numbers 164800 and 164810 as part of the pooled balance for the Asset line item for Premiums and Considerations. The Company reported the full balance of these general ledger accounts on the FFIC 2003 Annual Statement rather than allocating their pooled percentage to the companies participating in the Intercompany Reinsurance Agreement (pooling agreement). The Company should implement controls to ensure all accounts subject to pooling are properly pooled and appropriately allocated to each member.

Company Response: *The designation of pooling is assigned to an account during the creation of the account or through a change control. During 2003, the Company implemented additional controls to the change control process requiring all changes, including the creation of new accounts, to be approved by a cross-functional group that reviews and discusses all inter-dependencies and implications of each change control request.*

#### **6. Notes to the Financial Statements (Page 29)**

The Company could not provide an aging detail on a policy-by-policy basis for all of the over ninety day components of Premiums and Considerations. Consequently, the examiners were unable to determine compliance with SSAP No. 6, paragraph 7, which addresses the determination of the due date of premium balances due a company. The Company should implement procedures to ensure that over ninety balances due are supported by the underlying policy level detail and ensure this detail is available for review by auditors and regulators.

Company Response: *During 2004, the Company enhanced the Receivables Timeliness Facility (RTF) to include additional receivable systems as source support. RTF is an application for selecting various receivable aging reports generated from the majority of the Company's receivable systems, which is supported by the underlying policy level detail. The data is updated monthly and is available two weeks following the close.*

#### **7. Notes to the Financial Statements (Page 29)**

The California Department of Insurance (CDI) determined the loss and loss adjustment expense reserves shown by the pool as of December 31, 2003 were deficient by \$604,910,000. Of this deficiency, 2.5%, or \$15,122,750, would be allocated to AAIC. The Company should review its reserving process to ensure future reserve estimates are appropriate.

Company Response: *The Company has established policies and procedures around loss reserving as noted by the attached approved charter of Fireman's Fund Insurance Company's Reserve Committee.*

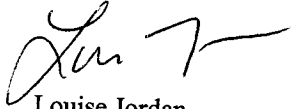
#### **8. Notes to the Financial Statements (Pages 28 and 29)**

In several instances, the Company's Annual Statement presentation was incorrect, including the misclassification of its investment in the Allianz Cash Pool LLC and the incorrect offsetting of reinsurance

premiums payable against reinsurance recoverables on paid losses. The Company should implement procedures and controls to ensure its Annual Statement presentation is consistent with the relevant SSAPs and Annual Statement Instructions.

Company Response: *The Company classified the Allianz Cash Pool, LLC as Other Invested Assets and reported it in Schedule BA in the 2004 annual statement. The Company manages and analyzes the separate recoverable/payable balances based on what is in the Integrated Reinsurance System, and ensures that the system reconciles to the general ledger. Additionally, management reviews the reclassification amounts between the recoverable/payable accounts to ensure they are immaterial.*

Sincerely,

A handwritten signature in black ink, appearing to read "Louise Jordan", with a stylized flourish extending to the right.

Louise Jordan  
Vice President and Controller  
Fireman's Fund Insurance Company